DOW THEORY LETTERS INC.

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THE MARKET: I cannot help but look with irony at the current comparison of Rails with Airlines. I spent half of my writing life during the late-1950's apologizing for the Rail Industry and the Rail Average in particular as a confirmatory tool of Dow's Theory. My readers in those days simply could not accept the Dow Theory tenet that the two Averages, Industrials and Rails, must confirm each other in order to lend authority to a price movement. "The Rails are a dying industry," I was informed, "The Rails will be out of business by 1965," I was told. "Why don't they substitute an average of Airlines or even Trucks," was the constant comment.

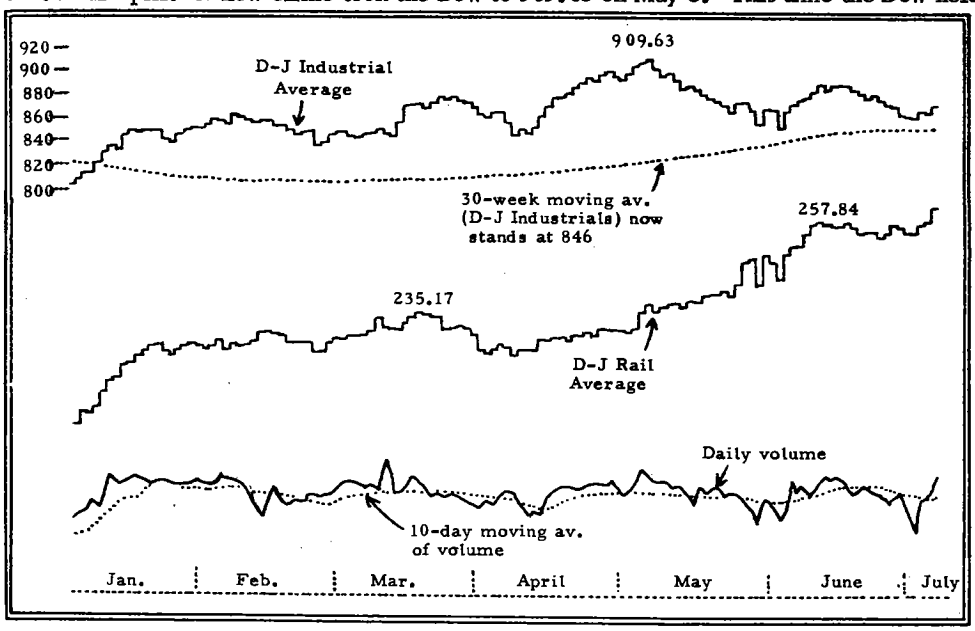
But now in 1967 I hear little of a disparaging nature about the Rails. Not only have Rails acted better than Airlines over recent months, but Rails have been the most powerful of the D-J Averages. Those who are still bulls on the market simply do not denigrate the "old Rail industry" any more.

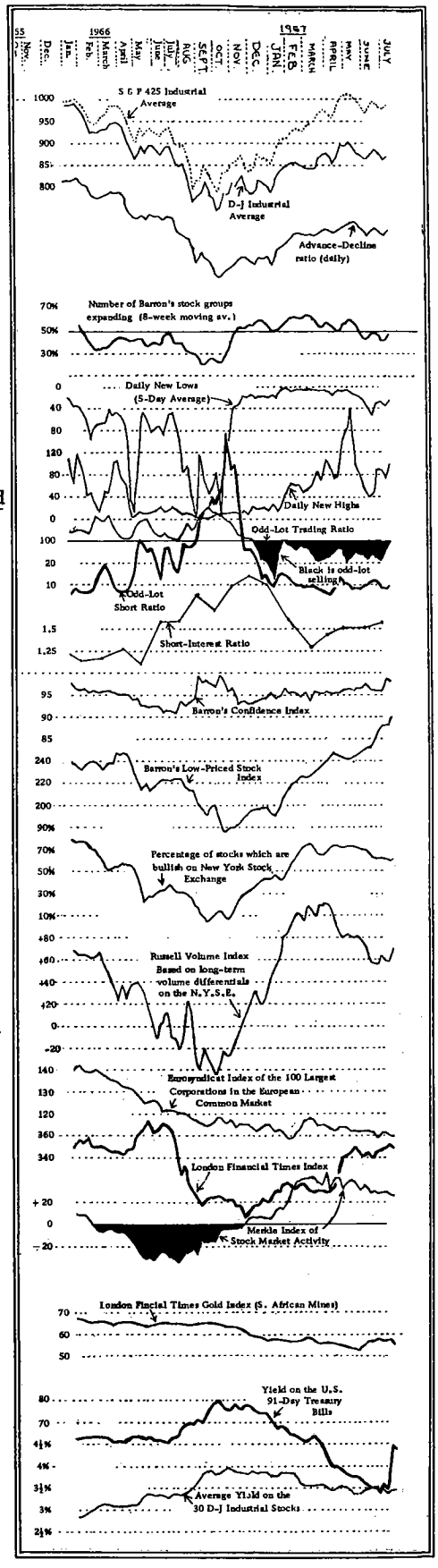
However, an orthodox interpretation of Dow's Theory continues to tell the story. The Industrials recorded their bear market recovery high on May 8 at 909.63. They have not yet surpassed that mark, despite the fact that Rails have traced a long series of unconfirmed new recovery highs. On June 19, Rails recorded a recovery high of 257.84. Since then the Rails have declined, then rallied to another series of unconfirmed recovery highs.

Nevertheless, the fact remains that the Averages have been "out-of-gear" on this bear rally since May 8, with non-confirmed highs by the Rails continuing for a period of over five weeks. This type of action has usually constituted a danger signal in the stock market. When it occurs following an extended retracement in a primary bear market I feel it should be accepted as a most serious warning signal.

I have written extensively regarding Dow's 50% Retracement Principle. Briefly this Principle states that what the Industrial Average does at the halfway level of the preceding major (extended) advance or decline is extremely significant. This is how I apply the Principle to the present market.

From February, 1966 to October, 1967, the Dow dropped from 995.15 to 744.32, a distance of 250.83 points. The halfway level of that decline was 869.73. In other words, what the Dow did on the retracement in relation to the 869.73 level would be most significant. The rally back from the October, 1966 lows carried to 876.67 on May 23, 1967. For a period of 6 trading days the Dow held above the 50% retracement level, then slid to 836.64 in April. A new climb took the Dow to 909.63 on May 8. This time the Dow held




1966
1967
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline ratio (daily)
Number of Barron's stock groups expanding (8-week moving av.)
Daily New Lows (5-Day Average)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-Lot Short Ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of stocks which are bullish on New York Stock Exchange
Russell Volume Index Based on long-term volume differentials on the N.Y.S.E.
Euroyndicat Index of the 100 Largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
London Fincial Times Gold Index (S. African Mines)
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

above the 50% retracement level for a period of 24 trading days. A second slide brought the Dow back to 852.56 on May 31. Most recently the Dow rose to 886.15 on June 13. This time the Dow held above the 50% retracement level for 13 days. On June 27 the Dow broke below the 50% level for the third time.

I took this performance to be rather ominous. So far in 1967, despite the most frenzied speculation in other segments of the market, despite a giant propaganda program on the part of Governmental and business leaders to the effect that "a late-1967 boom is in the bag," the Industrials have so far clawed above the 50% retracement level three times, but each time they have failed to hold.

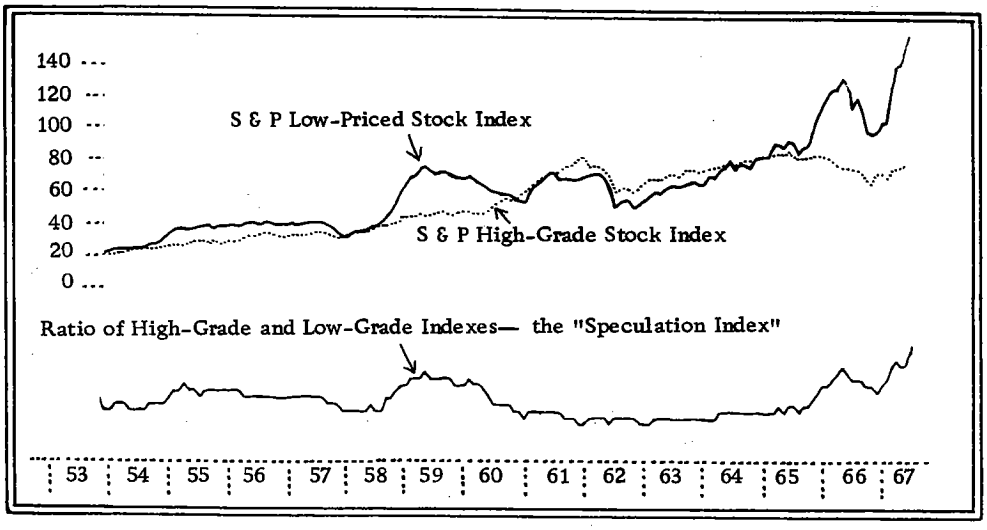
On the week ending June 30, Barron's Low-Priced Stock Index again edged to a record high (274.2) even while the blue-chip Dow Average lost 17.11 points. Thus the reckless speculation continued in the face of liquidation in the investment sector of the market. During the same week Barron's Highest-Grade Bond Index sagged to provide an all-time record yield of 5.77% (against an average yield of 3.47% on the Dow). The negative spread between the yield on the broad Standard & Poor 425 Industrial Average and the yield on the S & P Aaa Composite Bond Average expanded to an all-time high of 2.49% in favor of bonds. Yields on selected long-term Treasury bonds moved as high as 5.29% as prices of these bonds sagged to record lows. Volume on the speculative Amex Exchange continued to roar and for the week Amex volume was 54% of N.Y.S.E. volume (see chart in the last Letter).

I have outlined above a number of reasons for caution, or at least some of the rationales behind my own personal caution. But I want to remind subscribers that Wall Street is not, and never has been, a puzzle that could be consistently solved by mechanical formulas. Therefore, when I hear some analysts talking about "steady odd-lot selling" or "the high short interest" I am singularly unimpressed. To pin one's hopes on such gauges as the odd-lots or the short interest at this time strikes me as a totally "mechanical" approach to the market and one to be wary of. It reminds me of the amateur sailing enthusiast who knows everything about obtaining utmost speed when sailing downwind. So he gets out in the bay and lets out sail and applies everything according to the book. The only problem is that he is now heading upwind, and he should be tacking. His technique is classical, and his skill is superb. But the wind has shifted drastically, and our sailor is "living in the past." The technique which worked downwind proves utterly useless because the basic fundamentals have changed. Our sailor has failed to recognize that the wind direction has changed.

By the same token, many of the standard techniques, techniques which have been followed with reasonable success for the past 18 years (during which the primary trend was bullish), are apt to fail miserably as this bear market progresses. For instance, it is normal for a bear market to contain a large short interest. Figures tabulated from April, 1931 (the date of the Exchange's first data) through to July, 1932 (the bottom of the great bear market) indicate that the short interest was very high near the top of the bull market and that the short interest grew progressively smaller as the bear market progressed. For instance, from the high of 5.5 million shares short in May, 1931, the short interest dropped a whopping 71% to the September, 1932 low of 1.6 million shares. During that period the market collapsed. But the high short interest of May, 1931, did not prevent a collapse. And the low short interest of mid-1932 did not prevent a great new bull market from starting. In other words, the short interest behaves differently during a primary bull and bear market. And those who read this statistic in the same manner during bull and bear markets are going to be confused and make mistakes. It is a thought worth pondering.

In the final analysis, nothing will serve the investor better than intelligence, experience, and study. There is no substitute for an artful interpretation of the big picture and a "feel" for the market, and this can only be developed over successive bull and bear cycles. In a way, it is rather unfortunate that the cycles have been so extended during the post-1940 period. It has given few analysts a chance to test "feelings" and techniques through complete primary bull and bear swings. Such an opportunity, however, now appears in the offering. We had best make the most of it.

I have outlined some of the technical and practical problems inherent in analyzing this bear market. It is best to remember that a bear market is out to "break you" any way it can. If it is deceptive, so much the better for the bear. It is obvious that someone is going to be left holding the bag when the current speculative balloon finally explodes in Wall Street's face. Ultimately, there is going to be a mass exit from the market and a mass rush for cash. I feel the coming stampede could be worse than that witnessed in 1966 because the fundamentals are worse and we are further on (in time) and therefore nearer the moment of truth.



I will offer one final example. On June 21, the "Speculation Index," which is the ratio of Standard & Poor's High Grade stocks to S & P's Low-Grade stocks, touched an amazing 2.03 on June 30, its highest level in two decades

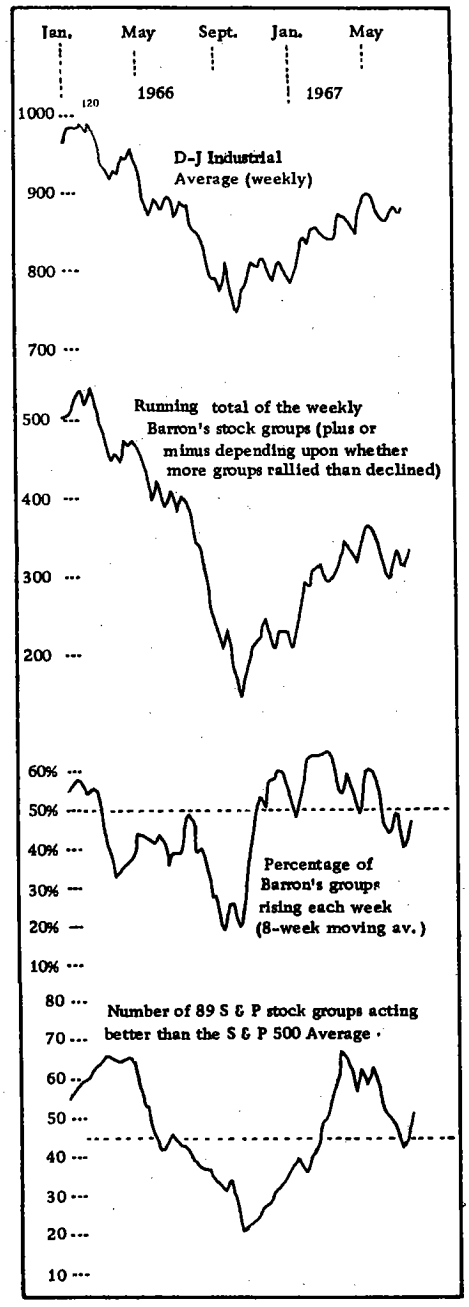
(see chart) and considerably higher than the peak of 1966. Time is running out for the speculative rallying forces in this market, and when the bear finally emerges full-blown from his lair, I believe there is going to be panic on the part of the speculators.

So again I will urge all my subscribers (particularly the many new ones) to get solvent, get out of equities, funds, utility stocks, preferred, what-have-you, and wait patiently for the bearish fireworks and ultimate great values which will appear as this market moves further on.

STOCK GROUPS: I have long used group studies as an aid in market analysis. However, I have seldom mentioned group studies in these Letters, and when I have mentioned them it has usually been within the context of relative strength in an individual group. I keep three types of group series at this office, and they are well worth examining at this time.

The accompanying chart traces the path of the D-J Industrials together with the plottings of these three group series. The first plotting (under the Dow) is, in effect, a weekly advance-decline ratio of the Barron's weekly group tabulations. (The various groups are listed in each issue of Barron's together with their percentage of advance or decline for the week).

How is the first series computed? The net difference in groups advancing or declining (plus or minus) is added to or subtracted from a running total. If 10 groups advanced and 25 declined then a minus 15 is the figure for the week. We then subtract 15 from the previous total.



Note on the chart that this "running total" group study tends to be coincident rather than leading. It is of interest, however, that this series halted its 1966-67 recovery movement far short of its 1966 peak. To this extent, it has confirmed the weakness of the Dow.

I believe that the second group study is more valuable from a timing standpoint. It is actually a percentage of groups advancing series. I have kept these statistics for seven years, and they have provided excellent signals for impending market rallies and declines. Each week the number of advancing Barron's groups are divided by the total number of groups. This provided the weekly "percentage of groups advancing." In order to smooth out the series, it is plotted on an 8-week moving average. I have decided to include this study as a regular feature of Dow Theory Letters and it will appear each week as the 4th graph line of the Composite Chart (page 1).

The percentage of groups advancing is now of particular interest. I watch this series from two standpoints (1) type of formation, and (2) distance above or below the 50% level. Only once before did this series form a head-and-shoulders pattern and then break below the 50% level. That was during late-1961 and early-1962. The completion of the right-shoulder coincided in 1962 with the collapse of the stock market. Now, in 1967 another head-and-shoulders pattern has formed. In May this pattern appeared to have been completed with the group percentage dropping below 50% on the week of May 22. At present the 8-week moving average of groups advancing is at 48, and this particular study is saying "careful."

The third group analysis has been developed by Chartcraft (Larchmont, N.Y.) and I find it both logical and useful. It is actually a group relative strength study. Each week Chartcraft arranges all 89 Standard & Poor stock groups in numbered tabulations ranging from 1 to 89. Obviously, number 1 is the strongest group while number 89 is the weakest. The tabulations are based on the relative strength of each group compared with the S & P 500 Stock Average, and each group's relative strength series is then arranged in the form of 17-week moving averages.

Chartcraft also publishes a weekly figure which shows the number of groups which are stronger than the S & P 500 Stock Average. These figures tend to range from a high of around 70 to a low of around 20. Those tabulations comprise the bottom groups study on the chart. The implication of this study is clearly seen. A first warning occurred in June when Chartcraft showed that less than half of their groups were acting better than the S & P 500 (latest figure is 52). Actually, Chartcraft plots these weekly totals on a point & figure chart, and this provided them with even earlier bull or bear signals. Their last bearish signal came in May when, at 57, the series gave a bearish signal by breaking below a consolidation formation. This consolidation can be seen by the little triangular pattern which developed during April and May of 1967.

 To sum up, the running total of groups (first series) is about keeping abreast of the Dow. The percentage of groups expanding (second series) is now looking weaker than at any time since 1966. The third series is well below its early 1967 high, but this series is improving with 52 out of 89 stock groups acting better than the S & P 500 Stock Average. I would say that taken together, these three studies are tending toward the weak side with the second series particularly weak.

WHAT THEY'RE SAYING: From Green's Commodity Market Comments (July 7): "The current declining trend in most commodity markets is somehow disquieting; we believe it to be a portent of what might happen soon in the stock market. Commodities usually lead the way — up and down — well in advance of stocks. The present weakness in most staples is remarkable, as no country has ever fought a war without an upside surge in commodity prices: this paradoxically demonstrates the strength of industrial America, though not necessarily the strength of the industrial averages. The stock market rally that started last October may end soon, as the slight expansion in business concomitant with large profit contraction which we are now witnessing is not the right feed for a stock market bull."

From the July 7 Worden Tape Reading Studies: "The rally which began this week (Dow up 8.79) is not without areas of strength and undoubtedly a few points could be scalped by able traders. A few stocks will probably perform dramatically. But the technical undertone is not such as to encourage even the nimblest traders. The risk of whipsaws and prematurely aborted moves is great. It is the ability to evaluate risk that, in the long run, makes either a successful trader or investor."

From the July 8 Drew Odd Lot Studies: "It is too early to say whether it (i.e., recent odd-lot buying) represents anything more than a seasonal phenomenon. We know that odd lot buying (or an increased rate of buying) will always appear in early July because of the high incidence of mid-year dividend payments which are largely reinvested. The amount is not so great as in early January, but it is enough to have an appreciable effect upon odd lot trading."

From Schaefer's July 8 Dow Theory Trader: "The market reminds me of the summer of 1929, and the rally which came during the Spring of 1930. Both were entirely too speculative, with about 30% to 40% of all stocks (mostly speculative issues) moving upwards to new highs, and both of these markets finally left the public out on a limb with nothing but losses and bankruptcies to show as a result of their gambling.....My guess is: the longer this speculative binge goes on, the greater will be the depression to follow."

From Dysart's Trendway Service of July 7: "Today all of these ways of measuring Breadth imply that the market lies near a mid-point of Breadth measurements of the past three years, and in that respect does not differ too much from the picture of the DJIA for the same period. Overhead lies dense resistance to much advance, while below lies a plentiful supply of money seeking 'a return' plus, hopefully, an adequate 'hedge' against inevitable inflation. A long stalemate could impend."

From the July 7 Granville Market Letter by Joe Granville: "Sporadic upside attempts are very unconvincing as the market moves deeper into the summer period. As the Dow-Jones Industrial Average seems to be holding above the June 5th lows by a slim and fragile margin, stocks within that average are being rapidly distributed. It is expected that this process will continue throughout this month with the floor caving in late this month or early August."

STOCKS: Even while rampant speculation buffets the Exchanges, even while the Amex slapped 100% margins in trading on 21 separate stocks in an effort to control the frenzy, the two mighty bellwethers of Wall Street, DuPont and General Motors, continued their dismal performances. These weekly charts depict the half-hearted rallies in GM and DD. The charts also show their relative strength lines flopping at the lowest point in 5 years for GM and the lowest point in a decade for DD. This is a bearish indication for these two issues, and history shows that whenever DD and GM act poorly, it is not long before the rest of the market follows. (Charts courtesy of Traders Research, 101 Cherry St., Alton, Ill. 62003).